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IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

HOUSTON LIGHTING & POWER COMPANY,

Appellant,

v.

PUBLIC UTILITY COMMISSION OF TEXAS,

Appellee.

On Appeal From The Supreme Court Of Texas

BRIEF OF GULF STATES UTILITIES COMPANY AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT

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QUESTIONS PRESENTED

Gulf States Utilities Company adopts the questions presented as set forth in the brief of appellant Houston Lighting & Power Company.

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BRIEF OF GULF STATES UTILITIES COMPANY AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT

Gulf States Utilities Company ("GSU" or "Company"), in accordance with Supreme Court Rule 36.1, respectfully submits its brief *amicus curiae* in support of the appeal filed by Houston Lighting & Power Company ("Houston") to review the decision of the Supreme Court of Texas of December 16, 1987, in *Public Utility Commission of Texas v. Houston Lighting & Power Company*, 748 S.W.2d 439 (Tex. 1987) ("*Houston*").[1]

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[1] GSU has obtained written consents of both parties to this case. The written consents have been filed with the Clerk of this Court.

INTEREST OF AMICUS CURIAE

GSU filed a brief *amicus curiae* in support of Houston's Motion for Rehearing before the Texas Supreme Court. The Company provides electric service to 555,000 customers in an area extending from Baton Rouge, Louisiana, to a point some fifty miles east of Austin, Texas. GSU is regulated by the Public Utility Commission of Texas ("PUC") as well as the Louisiana Public Service Commission and, at wholesale, by the Federal Energy Regulatory Commission.

In GSU's last rate proceeding before the PUC, certain costs were excluded from rate base and "held in abeyance" pending further review. In addition, other GSU costs were disallowed as imprudent. Finally, there are other non-utility operating expenses which the Company does not recover in rates. The tax benefits arising from the costs held in abeyance and disallowed, as well as the benefits arising from other "below-the-line" costs were accorded treatment similar to that ordered by the PUC and affirmed by the Texas Supreme Court in its Opinion and Judgment of December 16, 1987. The current tax benefits associated with the deductions relating to the costs held in abeyance, disallowed, or otherwise below-the-line and not recognized in rates were credited to ratepayers. The PUC's appropriation to ratepayers of tax benefits stemming from such below-the-line costs not recognized in the Company's rates, as applied to GSU, will seriously impact GSU's financial integrity. GSU is already on the brink of insolvency; indeed, the PUC's tax decision alone will result in lowering GSU's revenue requirement by about $30 million per year.

STATEMENT OF THE CASE

In 1972, Houston initiated plans to construct the Allen's Creek Nuclear Project ("ACNP"), a two-unit, 2400-megawatt plant. In 1976, Houston announced a modification to this plan, deciding instead to build only one of the 1200-megawatt units. Over the next few years, several events occurred which resulted in Houston's cancelling ACNP on August 26, 1982. This cancellation resulted in a loss of approximately $361 million. In 1982, Houston filed with the PUC an application for a rate increase which included as a cost the amortization to ratepayers of the ACNP expenditures.

The PUC determined that ACNP should have been cancelled on January 1, 1980, and that all costs relating to ACNP from that date until its cancellation in August 1982 were imprudent. The "imprudent" expenditure, totalling approximately $166 million, was disallowed and not recoverable from Houston's ratepayers. The PUC, changing its standard procedure (*see Public Utility Commission of Texas v. Houston Lighting & Power Company*, No. C-5705, On Motion for Rehearing, slip op. at 2 (Tex. May 4, 1988) (Wallace, dissenting)), also required Houston to provide its ratepayers the tax benefits associated with this loss, in the amount of $111 million.

The decision of the PUC was reversed by the trial court, and the trial court's decision was affirmed by the court of appeals. On appeal, the Texas Supreme Court reversed the lower courts and affirmed the PUC. The Opinion of the Texas Supreme Court gives the PUC discretion to appropriate for the ratepayer the tax benefits arising from disallowed or other below-the-line costs.

Having disallowed the $166 million cost and excluded it from Houston's utility cost of service, the PUC should have excluded the associated tax effects from cost of service as well. The tax effects of the loss would then inure to Houston's shareholders, not its ratepayers. Instead, the PUC purportedly exercising its discretion, with the Texas Supreme Court affirming, appropriated the tax benefits associated with these disallowed costs, in violation of the Fifth Amendment of the United States Constitution as applied to the States through the Due Process Clause of the Fourteenth Amendment.

Gulf States Utilities Company respectfully requests this Court to grant Houston's appeal and reverse the Opinion and Judgment rendered by the Texas Supreme Court on December 16, 1987.

ARGUMENT

I. THE DECISION OF THE SUPREME COURT OF TEXAS, REQUIRING HOUSTON TO REDUCE ITS RATES BY THE AMOUNT OF TAX BENEFITS RELATED TO ITS DISALLOWED COSTS, CONSTITUTES A TAKING WITHOUT COMPENSATION.

The Texas Supreme Court, in its Opinion and Judgment, required Houston to reduce its cost of service, on which its rates are based, by an amount equal to the tax benefits associated with the $166 million disallowance of ACNP costs. At the same time, the $166 million cost which gave rise to the tax benefits also was excluded from cost of service. This result constitutes a taking of property without compensation or due process in violation of the Fifth Amendment of the United States Constitution as applied to the States through the Due Process Clause of the Fourteenth Amendment.

A. The Tax Benefits Associated With the Disallowed ACNP Costs Should Inure to the Benefit of Houston's Shareholders.

The principle that utility regulators may not take non-utility property in order to subsidize utility rates is indisputable. Indeed, American public utility regulation rests upon that bedrock understanding. *See, e.g., Northern Pacific Railway Company v. North Dakota*, 236 U.S. 585, 595 (1915); *cf. El Paso Electric v. FERC*, 667 F.2d 462, 468 (5th Cir. 1983) (acknowledging that "customers should neither be burdened by losses from other service nor benefitted from non-jurisdictional profits").

Under the cost of service approach to ratemaking applied by the PUC, a utility must identify the total costs of providing utility service to its customers. *See* Section 39, Public Utility Regulatory Act, Art. 1445c, Tex. Rev. Stat. Cost of service is defined "as the sum of: (a) reasonable operating expenses, (b) depreciation expense, (c) taxes, and (d) a fair and reasonable return." *Suburban Utility Corporation v. Public Utility Commission of Texas*, 652 S.W.2d 358, 362 (Tex. 1983). *See also* 1 A.J.G. Priest, *Principles of Public Utility Ratemaking* 45 (1969). Only those costs *properly assigned to the utility operation* may be included in the cost of service. *Tennessee Gas Pipeline v. FERC*, 606 F.2d 1094, 1109 (D.C. Cir. 1979), *cert. denied*, 445 U.S. 920 (1980); *cf. Columbia Gulf Transmission Company*, 23 F.E.R.C. (CCH) ¶ 61,396, at 61,850 (1983) (costs are to be included only "on the basis of a causal link between the service the company provides them and the expenses the company reports").

The PUC's decision to disallow $166 million in ACNP costs precludes their recovery in rates, leaving these costs to be borne entirely by shareholders. Ratepayers never paid any part of this amount. Therefore, for utility ratemaking purposes, the $166 million disallowed costs associated with ACNP are to be treated as a non-utility or below-the-line cost.

The taxes normally included in a utility's cost of service are not "all taxes incurred by the utility" as stated by the Texas Supreme Court (*Houston*, 748 S.W.2d 441), but only those taxes incurred by the utility in providing utility service. Otherwise, all taxes paid by a utility, whether incurred to provide utility service to ratepayers or as a non-utility item, would be the responsibility of the ratepayers. However, ratepayers do not receive the benefit of a utility's non-utility income nor are they burdened with the detriment of the associated taxes. Neither should they benefit from the tax effects of a utility's non-utility losses where they are not burdened with the detriment of the losses. *City of Charlottesville, Virginia v. FERC*, 774 F.2d 1205, 1207 (D.C. Cir. 1985), *cert. denied*, ___U.S. ___, 106 S.Ct. 1515 (1986) ("*City of Charlottesville*"). Therefore, the tax effects of the disallowed ACNP costs, costs borne entirely by shareholders, should benefit the shareholders, not the ratepayers.

B. The PUC Confiscated Property From Houston's Shareholders Without Compensation.

The property here at issue is the tax benefit associated with the disallowed ACNP costs. The "benefit" in question in *Houston* is the reduction in taxes resulting from the loss deduction attributable to the

abandonment of property. The Texas Supreme Court determined that Houston's ratepayers are entitled to that benefit even though it was the shareholders, not the ratepayers, who paid for the abandoned property. The PUC, as affirmed by the Texas Supreme Court, having treated the $166 million of ACNP costs as non-utility property with no recognition in rates, have seized the associated tax benefits from the Houston shareholders without any form of compensation or due process. Similarly in GSU's case, the PUC has seized the tax benefits associated with various below-the-line costs and transferred some $30 million per year from shareholders to ratepayers without any compensation or due process.

As stated above, the principle that utility regulators may not take non-utility property in order to subsidize utility rates is well-founded. The question in a particular case, of course, is whether the regulatory treatment there at issue is a "taking". The character of the governmental action in this case is extraordinary despite the regulatory setting in which that action occurred. Behind the screen of a ratemaking proceeding, the PUC has seized the tax benefits related to an investment in property for which the PUC expressly denied shareholders any compensation.

After excluding Houston's $166 million investment from cost of service (as well as from rate base), the PUC appropriated for ratepayers the tax attributes of the investment, which the PUC valued at $111 million. Houston's cost of service, from which the $166 million "non-utility" investment already had been excluded, was reduced by $111 million to take the

entire benefit of the tax reduction. Of course, had Houston not made the $166 million investment, there would have been no associated tax effect nor would there have been any impact on Houston's cost of service. In fact, Houston did make the $166 million investment, and the PUC specifically excluded the amortization of the investment from recognition in Houston's rates. Whatever the merits of this exclusion as a ratemaking matter, had the PUC stopped at this point then the effect on Houston's ratepayers would be the same as if Houston had never made the investment, *i.e.*, there would be no effect on Houston's rates. However, the PUC went further, to seize the tax benefits of the investment from Houston's shareholders and appropriate them for Houston's ratepayers. The PUC has given Houston's ratepayers $111 million that they would not have had if Houston's shareholders had never invested the $166 million in ACNP, at the same time that the PUC has excluded the $166 million as a cost in determining Houston's rates.[2]

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[2] Simple justice requires that ratepayers should not benefit from the tax savings resulting from the utility's non-utility losses. *City of Charlottesville*, 774 F.2d at 1217. Otherwise, ratepayers may not pay any cost-of-service taxes, even though the utility itself has tax expenses. Consider a utility company with two non-utility operations—one which created a $100 tax refund, the other a $100 tax liability. The company's utility operations also produced a $100 tax liability. If the PUC's longstanding procedures are applied properly, the tax loss and tax liability resulting from the non-utility operations are not considered in determining cost-of-service tax expense. Then ratepayers would pay a $100 tax liability produced by the company's utility operations. Under the inequitable flow-through procedure adopted by the PUC, as affirmed by the Texas Supreme Court in *Hous-*

The constitutionality of such regulatory action must be tested under traditional Fifth and Fourteenth Amendment principles. *Brooks-Scanlon Company v. Railroad Commission of Louisiana*, 251 U.S. 396 (1920) ("*Brooks-Scanlon*"), is a case in point. In *Brooks-Scanlon*, the state railroad commission had refused to allow a timber company to abandon an unprofitable railroad operation on the ground that the company's non-utility operations generated sufficient income for the company to make a profit notwithstanding the loss from the railroad operation. The Court used ordinary Fifth and Fourteenth Amendment standards flatly to reject the view that benefits from non-utility property could be taken to reduce utility rates. *Id.* at 399. Similarly, this Court, upon review of this case, should conclude that the PUC's action, as affirmed by the Texas Supreme Court, is no less a confiscatory taking than that condemned by the Court in *Brooks-Scanlon*.

C. Frustration of Reasonable Investment-Backed Expectations Also Constitutes an Unconstitutional Taking.

The present case involves a taking like that found unconstitutional by the Court in *Ruckelshaus v. Monsanto*, 467 U.S. 986 (1984) ("*Monsanto*"). In *Monsanto*, the Court declared that an unconstitutional taking would exist if certain reasonable investment-backed expectations of Monsanto's shareholders were frustrated.[3]

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ton, the tax benefit of the non-utility loss is credited to the ratepayers while any non-utility tax liability is ignored. Hence, ratepayers pay no tax in cost-of-service even though utility operations created the liability. The result is that the company has a $100 utility tax liability borne solely by its shareholders.

[3] Over a period of years, Monsanto had submitted to the En-

The Court has ruled that neither complete destruction of property nor the exercise of physical control over property is necessary for an unconstitutional taking to occur. *See, e.g., Pennsylvania Coal Company v. Mahon*, 260 U.S. 393 (1922); *Kaiser Aetna v. United States*, 444 U.S. 164 (1979). As the Court declared in *Monsanto*, 467 U.S. at 1005, "Governmental action short of acquisition of title or occupancy has been held, if its effects are so complete as to deprive the owner of all or most of his interest in the subject matter, to amount to a taking", *quoting United States v. General Motors Corporation*, 323 U.S. 373, at 378 (1945).[4]

In *Monsanto*, the Court ruled that frustration of Monsanto's reasonable investment-backed expecta-

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vironmental Protection Agency ("EPA") data which Monsanto considered to be trade secrets. At all times during which Monsanto had submitted data to the EPA, it was aware of the standard operating procedure of the agency with respect to the confidentiality of information submitted.

With respect to data submitted when EPA was not required to maintain the confidentiality of data it received, the Court found that Monsanto could have no reasonable expectation in the confidentiality of the submitted data. However, the Court ruled that a reasonable investment-backed expectation did exist with regard to the treatment of information submitted while EPA had a mandate to maintain confidentiality of the data it received. Therefore, any unauthorized release or use of such information by the EPA would constitute a taking. *Monsanto*, 467 U.S. at 1011, 1013. The Court remanded the case for further proceedings to determine whether reasonable expectations existed with respect to the particular property at issue.

[4] The decision of the Texas Supreme Court, while not destroying or acquiring title to the tax benefits in question, effectively denies Houston's shareholders—the rightful owners—of *all* interest in these tax benefits and thus in property rights.

tions constituted a taking, where its shareholders' reasonable expectations related to the specific property in controversy. The present case presents the same frustration of investment-backed expectations without a similar question or uncertainty regarding the property in controversy. Houston's shareholders had a reasonable investment-backed expectation that, at worst, they would receive the tax benefits resulting from the loss incurred by a cancellation of ACNP. The PUC's ruling and the Texas Supreme Court's affirmance thereof deprived Houston's shareholders of that expectation.[5]

This Court should grant Houston's appeal in order to reaffirm its conclusion in *Monsanto* that regulatory frustration of reasonable investment-backed expectations constitutes a taking of property without compensation or due process in violation of the Fifth Amendment of the United States Constitution as applied to the States through the Due Process Clause of the Fourteenth Amendment.

II. THE COURT'S DECISION IN *FPC V. HOPE NATURAL GAS COMPANY* DOES NOT JUSTIFY THE ACTION OF THE PUC AND THE SUPREME COURT OF TEXAS.

The PUC may attempt to justify its actions on the basis of the declaration by the Court in *FPC v. Hope*

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[5] The GSU situation is even more compelling. Certain expenses, such as lobbying costs, were incurred by GSU shareholders with no intention even of attempting to recover these business expenses from ratepayers through rates. GSU shareholders' only reasonable expectation was that they would receive the tax benefits of the expenses, because shareholders alone bore the burden of those costs. The PUC has deprived GSU shareholders of that reasonable expectation by seizing the tax benefits and transferring them to GSU's ratepayers.

Natural Gas Company, 320 U.S. 591, 602 (1944) ("*Hope*"), that "it is the result reached and not the method employed which is controlling". However, while *Hope* indicates that rates which provide a reasonable return for the utility investment in property dedicated to public use are permissible, *Hope* does not sanction confiscation of non-utility property from a utility's shareholders in order to reduce utility rates. Moreover, *Hope* calls for a balancing of the interests of utility shareholders and ratepayers. *Id.* at 603.

Here, the action of the PUC is plainly beyond *Hope*. The PUC has taken property (the tax benefits associated with the $166 million disallowance) unrelated to the utility's allowed cost of service from its shareholders and appropriated them for the utility's ratepayers. The issue here is not the end result of the PUC's ratemaking determination of a utility's cost of service, but rather the PUC's appropriation of the tax benefits associated with property determined by it to be non-utility property for ratemaking purposes. The *Hope* decision might provide the test by which the adequacy of compensation for use of utility property is judged. However, the taking from shareholders of the tax effects of that disallowance is a confiscation of property that cannot be justified by the end result test applied to regulatory determinations of utility cost of service.

CONCLUSION

WHEREFORE, for the foregoing reasons, Gulf States Utilities Company respectfully requests the Court to grant Houston Lighting & Power Company's appeal and to reverse the decision of the Supreme Court of Texas.

Respectfully submitted,

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